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Hazards of Issuing Stock for Basis

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HAZARDS OF ISSUING STOCK FOR BASIS

— by Neil E. Harl*

The decisions made in issuing corporate stock in a tax-free exchange[1] can have important federal gift tax implications, depending upon how the stock is issued.[2] Especially for transfers involving related transferors, the gift tax consequences can be substantial.

Requirements for tax-free exchange

The requirements for a tax-free exchange of property to a newly-formed corporation in exchange for stock are relatively straightforward—(1) the transfer must be solely for stock in the corporation[3] and, (2) immediately after the exchange, the transferors must be in control of the corporation.[4] The term “in control” means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.[5] A shift in ownership of stock among the transferors after the exchange does not necessarily deny tax-free exchange treatment.[6] However, a transfer of more than 20 percent of the stock to persons other than the transferors can preclude a tax-free exchange.[7]

The income tax basis of stock or securities received by the transferors is the basis of property transferred, less boot received and plus gain recognized, if any.[8] If the sum of liabilities assumed or taken subject to by the corporation exceeds the aggregate basis of assets transferred, a taxable gain is incurred as to the excess.[9]

Issuing stock for basis

For some time, it has been strongly recommended that stock be issued for the fair market value of property transferred less the indebtedness assumed by the corporation.[10] Specifically, it has been recommended that stock not be issued for the income tax basis of the property transferred even though it is the practice of some practitioners, at least for firms on accrual accounting, to issue stock for the income tax basis of property transferred to the corporation.[11] The hazards of issuing stock for the income tax basis of property transferred are especially great in agriculture where low basis assets are quite common and the disparate relationship between income tax basis and fair market value of property can create serious problems of equity as between or among the transferors and potential gift tax problems.

Example: Alice Anderson, at the death of her husband in 1960, acquired full ownership of 480 acres of farmland. Her son, Tom, has been renting his mother’s farmland and had built up a line of machinery and a sizeable livestock program.

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Under pressure from creditors who were concerned about the deteriorating financial condition of the son, which had resulting in substantial part from expanding the livestock program, Alice and Tom agreed to form an operating corporation with Alice's land and Tom's machinery and livestock to be transferred to the newly-formed corporation. Alice's land had an income tax basis (derived principally from the federal estate tax value at her husband's death) of approximately $150,000 but with a fair market value of $1.2 million. Tom's machinery and livestock had a nearly identical income tax basis of about $150,000 but with a fair market value of about $151,000. The proposal was to issue a single class of common stock at $100 per share based on the income tax basis of the property transferred. This would have resulted in the issuance of 1500 shares of stock to Alice and 1500 shares of stock to Tom.

Transferor	**Assets Transferred**	**Income Tax Basis**	**Proposed Stock Issuance (shares)**	**Fair Market Value**
Alice	Land	$150,000	1500	1,200,000
Tom	Machinery & Livestock	$150,000	1500	151,000

Had the transfer been completed, which it was not, each would have acquired a block of stock worth approximately $675,500 (half the value of assets appraised at $1,351,000 ($1,200,000 + $151,000). If the corporation had been liquidated shortly after formation, Alice would have held property valued at $675,500 and yet would have given up land valued at $1.2 million. The difference, or $524,500, could have been characterized as a gift from Alice to Tom. The gift tax consequences would have been substantial.

Issuance of stock for the income tax basis of transferred assets is permissible in two situations—(1) where only one transferor is involved or (2) where, for all transferors, the income tax basis of transferred assets bears a uniform relationship to the fair market value of property transferred. The latter situation could arise if four children, for example, were to inherit a farm and, after several years, form a corporation and issue stock for basis. Even though the basis would be substantially less than fair market value, each transferor's basis would bear the same relationship to fair market value so no gift would result although the issuance of stock for basis would result in stock being worth significantly more than the value at which the stock was issued which can be misleading to the shareholders.

In conclusion

In order to avoid a gift on formation, it is clear that stock should be issued for fair market value less the amount of indebtedness taken over by the corporation.

FOOTNOTES

1 I.R.C. § 351. See generally 7 Harl, *Agricultural Law* §§ 53.02, 53.03 (2003); Harl, *Agricultural Law Manual* § 7.02[2][c] (2003).

2 See Treas. Reg. § 1.356-5(a).

3 I.R.C. § 351(a). For transfers on or before October 2, 1989, the requirement read "stock or securities" which permitted the issuance of qualifying debt securities in a tax-free exchange. I.R.C. § 351(a), before amendment by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, Sec. 7203, 103 Stat. 2333 (1989), amending I.R.C. § 351(a), (b), (d), (g). The 1989 amendment treats the issuance of debt securities as part of a tax-free exchange as boot. *Id.* For property transfers by a C corporation, the effective date was July 11, 1989, unless the 80 percent test of I.R.C. § 1504(a)(2) was met. *Id.*

4 *Id.*

5 I.R.C. §§ 351(a), 368(c).

6 Rev. Rul. 79-194, 1979-1 C.B. 145.

7 Intermountain Lumber Co. v. Comm'r, 65 T.C. 1025 (1976) stock sale was "integral part" of incorporation). But see Wilgard Realty Co. v. Comm'r, 127 F.2d 514 (2d Cir. 1942), *cert. denied*, 317 U.S. 655 (1942) (transfer of more than 20 percent of stock to members of family on day of receipt of stock from corporation did not preclude tax-free exchange).

8 I.R.C. §§ 351(b), 358(a)(1)(A).

9 I.R.C. § 357(c). See Seggerman Farms, Inc. v. Comm'r, T.C. Memo. 2001-99, *aff'd*, 308 F.3d 803 (7th Cir. 2002); Owen v. Comm'r, 881 F.2d 832 (9th Cir. 1989). But see Peracchi v. Comm'r, T.C. Memo. 1996-191, *rev'd*, 143 F.3d 487 (9th Cir. 1998) (unsecured promissory note prevented recognition of gain); Lessinger v. Comm'r, 85 T.C. 824 (1985), *rev'd*, 872 F.2d 519 (2d Cir. 1989) (no gain recognized on transfer of taxpayer's sole proprietorship assets and liabilities to taxpayer's wholly-owned corporation even though liabilities exceeded basis).

10 See 7 Harl, *supra* note 1, § 53.03[2][b].

11 See 7 Harl, *supra* note 1, § 53.03[2][b], note 55.